No. 92-1384

In The

Supreme Court of the United States

October Term, 1993

Barclays Bank PLC,
Petitioner,

v.

Franchise Tax Board,
An Agency Of The State Of California,
Respondent.

On Writ of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

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BRIEF OF THE GOVERNMENT OF THE UNITED KINGDOM AS AMICUS CURIAE IN SUPPORT OF PETITIONER

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INTEREST OF AMICUS CURIAE

The United Kingdom is one of the major trading partners of the United States. It has for many years been the largest direct investor in the United States, with an estimated $110 billion in such investments on an historical cost basis. Almost one thousand U.K.-owned multinational groups do business through approximately three thousand subsidiaries in virtually all the states of the Union. In order to encourage still greater investment and trade which

would redound to the benefit of both nations, the United Kingdom and the United States have sought consistently to apply the principles of the arm's length-separate accounting method in determining the proper international division of income for tax purposes. Both Nations believe application of this method protects their respective fiscs while preventing inappropriate double taxation of their taxpayers. It also creates a mechanism for resolving disputes and, more generally, provides the certainty in the taxation of international commerce that is sought by international investors.

The State of California, in the year in question, imposed mandatory worldwide unitary taxation—a system completely inconsistent with the arm's length-separate accounting method—on all corporations doing business in California. Barclays Bank of California ("Barcal"), a California corporation, and Barclays Bank International Limited ("BBI"), a U.K. company, subsidiaries of petitioner's predecessor, both did business in California. They were required to pay tax on their California income calculated with reference to the worldwide profits of the entire Barclays group—over 220 corporations conducting more than 98 percent of their business outside the United States. This resulted in substantially higher tax than would have arisen under application of the arm's length-separate accounting method.

The United Kingdom has a significant and legitimate interest in protecting U.K. multinational groups from damage caused by the imposition of worldwide unitary tax. It is greatly concerned that if mandatory worldwide unitary taxation of the type imposed by California were to be upheld, its multinationals would be adversely affected, the imposition of worldwide unitary taxation by the states would multiply, and, in seeking to protect its legitimate interests and those of its multinationals, its relations with the United States as a whole would be severely impaired. The Government of the United Kingdom believes that this

case provides the opportunity for this Court definitively to hold unconstitutional the imposition of mandatory worldwide unitary taxation by any State on companies that are part of a foreign-owned multinational group.

The Government of the United Kingdom submits this brief *amicus curiae* in support of petitioner.[1]

SUMMARY OF ARGUMENT

The Government of the United Kingdom believes that the instant case requires application of this Court's Dormant Foreign Commerce Clause analysis. Despite the assertions of the FTB and the holding of the California Supreme Court, the Government of the United Kingdom believes that Congress has not authorized the States of the Union to impose mandatory worldwide unitary taxation on foreign owned groups. In particular, nothing in the ratification process of the U.K.-U.S. Tax Treaty can be construed as approval—either affirmatively or by "negative implication."

The California worldwide unitary tax fails both of the tests specifically fashioned for Dormant Foreign Commerce Clause analysis in *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434 (1979): substantial risk of international multiple taxation and interference with the ability of the Federal Government to speak with one voice when regulating foreign commerce.

There can be no doubt that California's imposition of worldwide unitary taxation creates for foreign-owned groups a substantial risk of international double taxation in every case. While it may not always produce actual double taxation (although it did in the instant case), the risk is inevitable. The constitutional significance of the "mere *risk*" of double taxation was specifically reserved

[1] Petitioner and Respondent have consented to the filing of this brief *amicus curiae* in letters filed with the Clerk of this Court.

by this Court in *Japan Line*, and should be resolved now. The adverse impact of this risk on inbound foreign investment is manifest. Furthermore, as the dissent in *Container Corp.* v. *Franchise Tax Board*, 463 U.S. 159 (1983) pointed out, there is a reasonable alternative to worldwide unitary taxation, namely, "water's edge."

Mandatory worldwide unitary taxation also interferes with the Federal Government's ability to "speak with one voice" in regulating the foreign commerce of the United States. The most compelling manifestation of this interference has been the hostile reaction of foreign nations, and the United Kingdom in particular, with possible adverse consequences for this Nation as a whole. The United Kingdom enacted retaliatory legislation in 1985, and in 1993 came to the very brink of activating it. The justification for any such retaliation is clear—worldwide unitary taxation has an extraterritorial reach that places all foreign-owned multinationals at risk of double taxation, thereby requiring their residence countries either to allow them to suffer that burden or provide relief to the detriment of their own fiscs.

The Government of the United Kingdom also believes that California's worldwide unitary taxation fails the first of the *Complete Auto Transit, Inc.* v. *Brady*, 430 U.S. 274 (1977) tests, namely, "substantial nexus." In *Quill Corp.* v. *North Dakota*, 112 S.Ct. 1904 (1992), this Court established that the Commerce Clause requires a more significant level of contact than the "minimal" Due Process nexus requirements considered by this Court in *Container*. Because of the heavy burden a worldwide unitary tax imposes on foreign commerce, the requisite level of contact between the taxing state and the activities it would tax simply cannot be found with respect to those members of foreign-owned unitary groups that operate in foreign jurisdictions and have no connection with the United States other than through their corporate affiliation.

ARGUMENT

I. Congress Has Not Authorized States to Impose Mandatory Worldwide Unitary Taxation on Foreign-Owned Groups

A. General

1. Regulation of Foreign Commerce

The Government of the United Kingdom regards the issue presented by the instant case as posing the most fundamental of constitutional questions in the areas of federal-state relations and foreign relations. Under the U.S. Constitution, Congress is vested with the power "To regulate Commerce with foreign Nations. . . ." Art. I, § 8, cl. 3. Taxation is, of course, a form of regulation. Consequently, on the face of it, there would seem to be no power in the States to tax any aspect of foreign commerce in the absence of Congressional authorization to do so.

Even in the absence of such authorization, however, the States and their political subdivisions have undertaken to impose certain forms of taxation on foreign commerce. As a result, this Court has been called upon to determine the constitutionality of a variety of such taxes—Los Angeles County's ad valorem property tax on containers (struck down) in *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434 (1979); Florida's sales tax on aviation fuel (upheld) in *Wardair Canada, Inc.* v. *Florida Dep't of Revenue*, 477 U.S. 1 (1986); Iowa's income tax on foreign subsidiary dividends (struck down) in *Kraft Gen. Foods, Inc.* v. *Iowa Dep't of Revenue & Fin.*, 112 S. Ct. 2365 (1992); and Tennessee's sales tax on container leases (upheld) in *Itel Containers Int'l Corp.* v. *Huddleston*, 113 S.Ct. 1095 (1993). The most directly pertinent decision, of course, is *Container Corp.* v. *Franchise Tax Board*, 463 U.S. 159 (1983), in which this Court, by a 5-3 majority, upheld California's mandatory worldwide unitary income tax, but only in re-

lation to a domestic-owned group of corporations that included foreign subsidiaries.

All of these cases make it clear that absent an expression of Congressional intent that a particular state tax on foreign commerce is permissible, this Court will undertake to test the validity of the tax under the so-called Dormant Commerce Clause analysis that has been adhered to since the mid-nineteenth century.

2. Dormant Commerce Clause Analysis

Under Dormant Commerce Clause analysis, as applied to the Foreign Commerce Clause, this Court will strike down a tax if it fails any one of six different tests. The first four tests were originally set forth in *Complete Auto Transit, Inc.* v. *Brady,* 430 U.S. 274 (1977), a case involving the Interstate Commerce Clause. They were extended to the Foreign Commerce Clause in *Japan Line, supra.* They require that (1) there must be "substantial nexus" between the activities being taxed and the taxing state, (2) the tax must be fairly apportioned, (3) the tax must not be discriminatory against foreign commerce, and (4) the tax must be fairly related to the services received from the taxing jurisdiction.[2] *Japan Line,* 441 U.S. at 444-446. The remaining two Foreign Commerce Clause tests, set forth by this Court for the first time in *Japan Line,* are that (5) the tax must not create a substantial risk of international multiple taxation, and (6) the tax must not prevent the Federal Government from speaking with one voice when regulating commercial relations with foreign governments. *Id.* at 451.

The Government of the United Kingdom is aware of no affirmative legislation enacted by Congress that authorizes the imposition by individual States of worldwide unitary taxation on foreign-owned multinational groups. Neverthe-

[2] The tests set out in (2), (3), and (4) are not considered in this brief *amicus curiae.*

less, the California Supreme Court, while not disagreeing with that proposition, concluded by process of "negative implication" that Congress had in fact authorized the States to utilize that method of taxation. As a result, the California Supreme Court concluded that there was no need to engage in Dormant Foreign Commerce Clause analysis.

The Government of the United Kingdom believes that the analysis of the California Supreme Court is subject to "serious question" (*see* Brief for the United States as *Amicus Curiae,* filed October 7, 1993, at 7). It wishes specifically to address one of the points on which the court below relied in finding its "negative implication." That point involves the developments relating to the approval and ratification of the United Kingdom-United States Double Taxation Treaty (the "U.K.-U.S. Treaty") in the late 1970's.

B. Ratification of the U.K.-U.S. Treaty

In both the decision of the California Supreme Court and the brief of respondent Franchise Tax Board ("FTB") in opposition to certiorari, much has been made of the reservation by the U.S. Senate to a portion of Article 9(4) of the U.K.-U.S. Treaty and the subsequent approval of the revised treaty by the U.K. Parliament.[3]

The Government of the United Kingdom does not now, and did not either at the time of the reservation by the U.S. Senate or at the time of ultimate approval by the

[3] As originally drafted, Article 9(4) would have expressly precluded the States from imposing worldwide unitary taxation on members of a U.K.-owned multinational group.

A majority of the Senate, but not the necessary two-thirds, approved the Treaty with Article 9(4) in its original form. A reservation to remove the prohibition on the States from the scope of Article 9(4) failed on a separate vote. After parliamentary maneuvering, however, the Senate then ratified the Treaty with the reservation attached.

U.K. Parliament, believe that the action of the Senate constituted "Federal acquiescence" in California's system of worldwide unitary taxation. Furthermore, the Government of the United Kingdom, in the strongest possible terms, wishes to disabuse this Court of any impression that the approval of the U.K.-U.S. Treaty by the U.K. Parliament in any particular constituted acceptance by the United Kingdom of California's imposition of worldwide unitary taxation on U.K.-owned groups.

1. The Senate Reservation

After reading this Court's decision in *Wardair* as establishing "a kind of protocol for identifying those kinds of governmental silences that give rise to 'negative implications' supporting an inference of Federal acquiescence in the state tax case under challenge," App. at C-34[4] the California Supreme Court completely misconstrued the significance of the Senate's reservation.

As described by that court, the reservation was "the most explicit example of a persistent Congressional refusal to enact curbs on the states' use of worldwide formula apportionment . . . ." App. at C-23. It is clear from all the differing opinions expressed both in the Senate debate and in committee, however, that there was no single Congressional policy underlying the reservation. Moreover, only one House of Congress considered the treaty in any event.

During the debates on the treaty in June 1978, three distinct views on Article 9(4) emerged. There were those who would vote for it, those who would vote against it because they thought the states should have the unfettered right to tax foreign-owned multinationals, and those who would vote against it because they did not believe that a

[4] All references to pages A-___, B-___, and C-___ are to pages in the Appendices to Petition for a Writ of Certiorari filed in the instant case. All references to exhibits are to those numbered in the Joint Stipulation of Facts on pages A-36 to A-73.

single bilateral tax treaty to be placed only before the Senate was the proper vehicle for considering a measure that should be acted on by both Houses as part of a uniform policy to be applied to all nations.

The importance attached to this third factor was attested to throughout the debates. The chief opponent of the original Article 9(4), Senator Church, stated:

> If accepted by the Senate, this provision could serve as a precedent for fashioning internal tax policy via agreements with foreign governments—a method that circumvents the tax writing committees of both the House and the Senate. This is the first time the treaty power has been used in such a manner, and, I believe, it represents an unwarranted extension of that power which we will come to regret.

124 Cong. Rec. 16892 (1978).

Similarly, Senator Stevens stated: "I suggest that a tax treaty is not the proper nor desirable medium for the exercise of this [Federal] power." (*Id.* at 18427.)

If this were not clear enough, it is given added force by the 1979 Senate Foreign Relations Committee report on the Third Protocol to the U.K.-U.S. Treaty (not cited by the California Supreme Court), which gave formal effect to the Senate reservation. The Foreign Relations Committee stated that:

> Even some supporters of Article 9(4), while not questioning the propriety of the Article, indicated their preference for Congressional consideration through the legislative process of the issue. The Foreign Relations Committee notes that Section 303 of S. 983, the Interstate Taxation bill introduced by Senator Mathias, would accomplish for all nations what Article 9(4) of the U.S.-U.K. Tax Treaty sought to accomplish for the U.K.

> The Committee urges the tax-writing Committees of the Congress—the Finance and the Ways & Means Committee—to hold hearings in the very near future on S. 983 in order to permit all sides of the issue to have their views known for the record. In addition, such legislation will give the Congress, which has the responsibility to resolve on the federal level inconsistent state taxation policies, the opportunity to take a position on the merits of the case.

Exhibit 37b.

From this, it seems clear that the Senate Foreign Relations Committee—the Committee responsible for the ratification process—in no way considered the Senate votes on Article 9(4) as themselves somehow having been intended to authorize state use of worldwide unitary taxation.

Yet, from the Senate's action on this one bilateral treaty—not 70 bilateral agreements and a 157-nation international agreement as considered in *Wardair*—and from the many motives expressed by Senators rather than one consistent theme, the California Supreme Court somehow discerned what it believed to be clear congressional intent. The Government of the United Kingdom does not see how the equivocal actions of the Senate with respect to a single treaty (where a majority of the Senators actually voted in favor of the original Article 9(4)) could be held to constitute Congressional approval of the states' use of worldwide unitary taxation.

2. Approval by the U.K. Parliament

The California Supreme Court also suggested (citing *Wardair*, 477 U.S. at 11) that the U.K.'s ratification of the treaty "must be understood as representing a policy

choice by the contracting parties."[5] App. at C-30. Furthermore, in its brief in opposition to certiorari, the FTB stated "The government of the United Kingdom, while regretting the defeat of the prohibition as preliminarily negotiated in 1975, recognized that the US/UK Treaty as finally negotiated and ratified was a 'fair and balanced agreement.' " FTB Opp. at 6.

The Government of the United Kingdom wishes firmly to reject the impression conveyed by the California Supreme Court and the FTB regarding its intentions in approving the Treaty. The FTB extracted the quoted phrase out of context from a demarche of March 25, 1980 sent to the State Department upon the exchange of instruments of ratification bringing the Treaty into force. The penultimate paragraph of the demarche directly addressed the unitary tax issue:

> Her Majesty's Government has recognized, in ratifying this Convention with the approval of the United Kingdom Parliament, and in its acceptance of the United States Senate reservation against Article 9(4) of the Convention, the dif-

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[5] The court went on to buttress its argument by contending that the "international business community" had somehow been on "notice" as to worldwide unitary taxation for the last seventy years. App. at C-32. The court's reliance on the 1924 decision in *Bass, Ratcliff & Gretton, Ltd.* v. *State Tax Comm'n*, 266 U.S. 271 (1924), in that regard is misplaced: that case involved only formulary apportionment of a single entity (combined reporting on a worldwide basis was not yet invented) and it also preceded both the adoption of the international arm's length standard and this Court's modern Commerce Clause jurisprudence.

Moreover, *Bass, Ratcliff* was not an income tax case. It involved a franchise tax imposed for the privilege of doing business in New York. The measure of the tax was net income for the prior year, computed on an apportionment basis. The taxpayer, a U.K. corporation, manufactured ale in England and sold it in New York and elsewhere. Even though the taxpayer suffered a loss on its New York operations in the prior year, this Court upheld application of the tax for the privilege of doing business in the current year.

> ficult issues raised within the United States in seeking to limit State taxing powers through the double taxation conventions of the United States. It has also recognized the importance of the Convention in its many other aspects for the two Governments and for the business and investment communities on each side. *It must be emphasized however that the acceptance of the Senate reservation in no way implies approval of the unitary basis* and it is the urgent request of Her Majesty's Government for the reasons given in this Note that the Government of the United States should use its best endeavours to eliminate the international application of the unitary basis of taxation. (emphasis added.)

Exhibit 32c.

For the reasons set forth above, as well as those set forth by petitioner in its brief, the Government of the United Kingdom strongly urges this Court to reject the analysis of the court below and acknowledge that the instant case presents a question for decision under the Dormant Foreign Commerce Clause.

II. Issues Under the Dormant Foreign Commerce Clause

Moving first to the two tests that this Court has fashioned peculiarly for Dormant Foreign Commerce Clause analysis, the Government of the United Kingdom believes that California's worldwide unitary tax fails both tests. As will be shown below, California's taxing scheme "creates a substantial risk of international multiple taxation" *Japan Line*, 441 U.S. at 451, and, in this case, actual double taxation. It also interferes with the ability of the Federal Government to speak with one voice in its regulation of commercial relations with foreign governments.

A. Substantial Risk of International Multiple Taxation

Because there was in fact inevitable actual double taxation in *Japan Line*, this Court specifically reserved the issue whether the "mere *risk*" of such taxation would result in unconstitutionality.

> Because California's tax in this case creates multiple taxation in fact, we have no occasion here to decide under what circumstances the mere *risk* of multiple taxation would invalidate a state tax, or whether this risk would be evaluated differently in foreign, as opposed to interstate, commerce.

Japan Line, 441 U.S. at 452 n.17 (emphasis in original) (citations omitted).

Since actual double taxation of income may not be inevitable under worldwide unitary taxation, the Government of the United Kingdom believes that the instant case presents the proper occasion for this Court to resolve the issue left open in *Japan Line*.

In *Container*, this Court declined a similar opportunity. The majority apparently believed that *Japan Line* required a showing of actual double taxation in every instance before the California unitary tax could be found to violate the "multiple taxation" test. In any event, the majority identified two inquiries to be undertaken in applying the multiple taxation test:

> Although double taxation in the foreign commerce context deserves to receive close scrutiny, that scrutiny must take into account the context in which the double taxation takes place and the alternatives reasonably available to the taxing state.

Container, 463 U.S. at 189.

The "context" on which the majority focused in *Container* was the fact that an income tax, rather than a property tax, was involved. The difficulties identified in dividing income among taxing jurisdictions apparently caused the majority to be unsympathetic to the taxpayer's double taxation claim. The "alternatives" which the majority said were available to California were either to refrain from taxing income altogether or to adopt the arm's length method of taxation. Neither alternative was found acceptable as applied to a domestic-owned group.

1. Context Revisited

The tax here involved is also an income tax—indeed, the same tax that was involved in *Container*. However, the group bearing the burden of the tax here is foreign-owned rather than domestic-owned as in *Container*. As will be shown, foreign-owned groups considering doing business in California are *inevitably* exposed to a substantial risk of international double taxation under the California taxing scheme. For the reasons noted below, that fact should be sufficient to render California's tax unconstitutional when applied to foreign-owned groups.

California's system of worldwide combined reporting requires a taxpayer in a foreign-owned group to include in its California tax base the entire worldwide income earned by the group as a whole. That is the essence of the unitary business concept—flows of value within the group justify treating it as if it were essentially a single entity. Yet all but the U.S. portion of that income would have been subject to tax in other countries under the arm's length-separate accounting method that is the international norm. Requiring the non-U.S. portion of the income, as so computed, to be included in the California tax base thus guarantees not only that it will be exposed to a second tax, but to a second tax computed on a different and inconsistent basis (i.e., formulary apportionment).

There is, in short, a conceptual clash between the arm's length method and worldwide unitary taxation—the former being fact-specific and applied on a transaction-by-transaction basis, the latter being entirely formulaic and computed by reference to global figures accumulated on an annual basis. There is simply no harmony between the two systems. Whether actual double taxation in fact will result in any given case where the two systems are applied becomes a matter of pure chance.[6] It is hard to imagine a clearer example of a tax giving rise to a "substantial risk of international multiple taxation" than a worldwide unitary tax imposed on a tax base that includes income that has also been subject to tax in another jurisdiction under the arm's length method.

While the same substantial risk of double taxation theoretically exists in the case of a domestic-owned group with foreign subsidiaries, it does not necessarily lead to a comparable indication of constitutional infirmity. In the context of business conducted within the United States, i.e., interstate commerce, this Court has allowed the States a certain amount of flexibility in applying apportionment formulae to the income of a unitary business. *Moorman Mfg. Co.* v. *Bair*, 437 U.S. 267 (1978) (Iowa single sales factor formula upheld even though neighboring Illinois used

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[6] If the apportionment formula produces a result that is less than the U.S. portion of the group's worldwide income, computed on an arm's length basis, no double taxation of income will occur. If the formula produces a greater result, double taxation of some portion of the group's non-U.S. source income will occur.

It is no answer to suggest that California is only taxing that portion of the group's income fairly attributable to it, not a portion of worldwide income *per se*. If the business is unitary, all of the income goes into a single pool. The rationale for apportionment is that all members of the group have contributed to the total amount in the pool, and the states where they operate may each tax some portion of the whole. That is why under unitary taxation even a loss company may find itself paying tax on apportioned income. California cannot have it both ways.

three-factor formula). Possible overlaps in formulae among the States may in fact result in some domestic double taxation. Yet this Court has concluded that because it does not sit as the legislature of last resort, it will uphold any domestic apportionment formula that is reasonable in application, notwithstanding possible overlaps and resulting double taxation.

Since *Container* involved a domestic parent company doing business in California, the fact that the income of its foreign subsidiaries was included in California's tax base for apportionment purposes and that the formula applied by California produced actual double taxation in that case (463 U.S. at 187 n. 22) essentially reflected an extension of the principles set down in *Moorman*. *See Container*, citing *Moorman*, 463 U.S. at 192-193. The possibility of an overlap of this sort is simply one of the accepted hazards under which domestic-owned businesses know they must operate. The principles of *Moorman* have never been applied to foreign-owned groups, however.

The reason why a substantial risk of double taxation is of greater constitutional significance in the case of foreign-owned, as contrasted with domestic-owned, groups is the adverse impact that the risk has on inbound international investment. The international commitment to use of the arm's length-separate accounting method for dividing income is designed to provide assurances to international investors that they should not suffer inappropriate double taxation on the profits from their investments. If a State is allowed to apply worldwide unitary taxation to international income, no such assurances can be given. That, in turn, plainly serves to discourage international investment in unitary states and, as a result, adversely affects the United States as a whole.

Presumably for these very reasons, the Secretary of State, the Honorable George P. Shultz, wrote to the Governors of California and other unitary tax States in 1986

to express the foreign policy concerns of the United States in relation to the imposition of worldwide unitary taxation and its effect on international investment.

> In an environment in which separate accounting is the federal policy and the generally accepted international rule, state taxation on a worldwide unitary basis creates a clear risk of double taxation. . . . This risk of double taxation may distort investment decisions, thereby reducing the overall flow of investment into the United States.

Exhibit 46h.

While actual double taxation may not be inevitable under California's taxing scheme (although petitioner did suffer such double taxation here), that fact should not relieve the California tax of its infirmity. The question reserved in *Japan Line* was whether the "mere *risk*" of multiple taxation was sufficient to invalidate a state tax, particularly in the case of foreign commerce. That question should now be answered in the affirmative. Any state tax that inevitably exposes foreign-owned groups to a substantial risk of multiple taxation directly interferes with inbound investment decisions. As a result, it places an undue burden on foreign commerce and should be invalidated under the Foreign Commerce Clause.

2. Alternative Taxing Methods

The majority in *Container* appears to have believed that there were only two alternatives to worldwide unitary taxation that were open to the State of California: the arm's length method or no tax at all. 463 U.S. at 190. As the minority pointed out, however, there is a third alternative: the so-called "water's edge" method. *Id.* at 198-199 n.1.

The "water's edge" method is designed to apply unitary taxation and formulary apportionment only to income arising within the United States. Under a water's edge approach, therefore, domestic source income could continue

to be apportioned among the states in time-honored fashion. But the tax could also be applied on a basis consistent with the Federal treatment of international income because the tax base would not include income determined under the arm's length method to have had its source in other countries.

The water's edge method is clearly an alternative "reasonably available to the taxing state". California recently adopted a new elective variation of the water's edge method in the amendatory legislation it enacted in October 1993. The availability of the water's edge alternative permits the conclusion that the inevitable *risk* of double taxation should itself be sufficient to invalidate worldwide unitary taxation when imposed on foreign-owned groups.

B. Speaking with One Voice

1. In General

Under the Constitution, the Federal Government is charged with responsibility for the policies of the United States regarding all matters involving foreign commerce. That is one proposition on which the Framers were most insistent when they agreed upon the distribution of powers between the Federal and State governments. *See Japan Line*, 441 U.S. at 449; *Michelin Tire Corp.* v. *Wages*, 423 U.S. 276, 283-286 (1976).

The States, therefore, may not conduct their affairs in a manner that interferes with the foreign policy of the Nation. The question presented here is whether California's imposition of worldwide unitary taxation on foreign-owned groups impermissibly interferes with the Federal Government's conduct of its commercial relations with foreign nations.

In both *Japan Line* and *Container*, one of the principal concerns of this Court in considering the "one voice" test was whether the nature and scope of the state tax in question created a significant prospect of retaliation against

the United States as a whole by the affected foreign government(s). A state tax that could provoke such retaliation would obviously represent a serious interference with the conduct of foreign commercial relations. There can be no clearer illustration of how an inappropriate state taxing scheme can spark the type of foreign government reaction that jeopardizes the conduct of foreign commercial relations than the response to California's imposition of its worldwide unitary tax on foreign-owned groups.

2. Retaliation and the United Kingdom

The Government of the United Kingdom wishes to reiterate to this Court that its acceptance of the U.K.-U.S. Treaty with the Article 9(4) reservation did not constitute acceptance of the California system of worldwide unitary taxation. It also did not quiet the strong demands for action on the issue in the U.K. Parliament that ultimately resulted in the enactment of specific retaliatory legislation.

The foundation for that legislation can be traced to a December 17, 1981 letter from the then Chancellor of the Exchequer, the Rt. Hon. Sir Geoffrey Howe, Q.C., M.P., to the U.S. Secretary of the Treasury, the Honorable Donald T. Regan. (The letter was appended to the Administration's brief *amicus curiae* filed in this Court in support of the petitioner in *Chicago Bridge & Iron Co.* v. *Caterpillar Tractor Co.*, 454 U.S. 1029 (1981), *appeal dismissed*, 463 U.S. 1220 (1983)). In that letter, the Chancellor stated that worldwide unitary taxation:

> . . . introduces an undesirably asymmetric element into the tax relationship between our two countries, since the unitary basis of taxation with worldwide combined reporting is not used by the U.K. at any level of government. This imbalance is causing increasing concern, not only on the part of British companies which have made rep-

> resentations about it, but in Parliament where Questions have been asked.[7]

Following the 1983 decision of this Court in *Container*, President Reagan formed a Working Group on Worldwide Unitary Taxation that was charged with studying the issue and making recommendations for action. The Working Group recommended a water's edge solution, but no concrete action resulted.

Concerned about the progress being made on the subject in the United States, Parliament proceeded to enact legislation in 1985 that gave the United Kingdom power to retaliate against national and subnational authorities that imposed worldwide unitary taxation on U.K.-owned companies. The legislation authorized, in respect of any U.S. corporation having a "qualifying presence" in a "unitary state," the withdrawal of the right to claim the partial tax credit given by the U.K. under the U.K.-U.S. Treaty in respect of dividends paid by a U.K. subsidiary. (The legislation is now contained in sections 812-815 of the Income and Corporation Taxes Act 1988.)

After Parliament's passage of the retaliatory legislation, California enacted its own legislation in 1986. For the first time, it provided a water's edge election for multinational groups, beginning in 1988. The change was generally considered unacceptable to the multinational community because of its conditionality, including the imposition of a substantial fee and the retention by the State of a right to impose unitary tax notwithstanding the election. Nevertheless, the fact that California had taken some steps, coupled with the commencement of the instant litigation in the California courts as a test case for foreign-owned

[7] Brief *Amicus Curiae* of the United States, in *Chicago Bridge & Iron Co.* v. *Caterpillar Tractor Co.*, App. at 3a, Docket No. 81-349. "Questions" in Parliament are the traditional means whereby M.P.'s express concern to the Government.

groups, caused the Government of the United Kingdom to defer implementation of its retaliatory legislation at that time.

Eventually, faced with the prospect of no immediate solution to the problem, the then Chancellor of the Exchequer, the Rt. Hon. Norman Lamont, M.P., announced in May 1993 that the Government of the United Kingdom would have to take retaliatory measures in respect of California's worldwide unitary tax if the matter were not satisfactorily resolved by the end of the year.

> . . . I have informed [the U.S. Secretary of the Treasury] that the Government will have to take retaliatory measures in relation to United States based companies if there is not a satisfactory resolution of the problem of the internationally-opposed unitary tax on foreign-owned companies in California by the end of this year.[8]

Following this announcement, the U.K. Board of Inland Revenue notified 900 major U.S. corporations with U.K. subsidiaries of the various retaliatory options available to it under the 1985 U.K. legislation.

In response to the 1993 developments, the California legislature adopted certain further modifications to its water's edge election, effective in 1994. This action prompted the Chancellor of the Exchequer, the Rt. Hon. Kenneth Clarke, Q.C., M.P., to inform the U.S. Secretary of the Treasury, the Honorable Lloyd Bentsen, that the United Kingdom would defer the implementation of any retaliatory measures in 1993 and would retaliate only if it became clear that the new legislation was being applied

[8] Statement of the Chancellor of the Exchequer, the Rt. Hon. Norman Lamont, M.P., May 13, 1993.

in a way that damaged U.K.-owned companies.[9] This position was expanded upon in the Chancellor's public statement of September 15, 1993:

> While the legislation in California is a significant step forward, on its own it does not provide a complete solution to the unitary tax problem. For a complete solution it will be necessary to have the internationally accepted arm's length principle endorsed, on a permanent basis, as the only valid method of taxing foreign companies in any State. Success for the Barclays case in the Supreme Court would achieve this. The Government will continue strongly to support Barclays' case. I hope it will succeed. If it does not, the UK will have to retain its retaliatory powers in reserve as a barrier against the possibility that States might damage UK owned companies by the imposition of unitary taxation at some time in the future.[10]

In *Container*, the majority concluded that because the legal incidence of the California tax fell on a domestic corporation (albeit one with foreign subsidiaries), foreign governments would not be justified in engaging in significant retaliation. 463 U.S. at 194-195. In so concluding, the majority expressly acknowledged that the result might well be different if the tax fell on a domestic corporation that was owned by foreign interests. *Id.* at 195 n.32. Here, the legal incidence of the tax fell on Barcal (a domestic subsidiary) and BBI (a U.K. subsidiary doing business in California) when both were owned by foreign interests (i.e.,

[9] Letter of Chancellor of the Exchequer, the Rt. Hon. Kenneth Clarke, Q.C., M.P. to U.S. Secretary of the Treasury, the Honorable Lloyd Bentsen, September 14, 1993.

[10] Statement of the Chancellor of the Exchequer, the Rt. Hon. Kenneth Clarke, Q.C., M.P., September 15, 1993.

petitioner's predecessor). The circumstances are thus quite different than in *Container*.

There can be no doubt about the overwhelmingly hostile reaction in the U.K. (and elsewhere) to California's worldwide unitary taxation as imposed on foreign-owned groups. There can also be no doubt that the tax has had an extremely adverse effect upon the foreign commercial relations of the United States. For its own part, the Government of the United Kingdom considers that it has not before come so close to retaliating economically against another sovereign nation over an issue of taxation, and certainly has never previously come so close to economic retaliation against a sovereign nation over the taxation activities of a political subdivision thereof.

3. Reaction of Other Governments

That California's taxing scheme interferes with the ability of the Federal Government to conduct its foreign commercial relations indisputable. If further proof is needed, it can be found in the reaction to California's tax by many of the other major trading partners of the United States. In the last fifteen years, more than twenty diplomatic notes and other formal communications have been sent to the State Department objecting to worldwide unitary taxation. Those demarches have spelled out the attitude of numerous foreign governments to the California tax. In addition, twenty OECD nations wishing to make their views even more clearly known to this Court have joined in the filing of a separate brief *amici curiae* in support of petitioner in the instant case. The Government of the United Kingdom knows of no other state tax that has ever engendered such a powerful reaction from foreign governments.

Given the extraterritorial reach of the California tax and the fact that both the legal incidence and the economic burden of the tax fall on foreign interests in the instant case, coupled with the inevitable exposure of such foreign-

owned groups to the substantial risk of double taxation, actual retaliation by a foreign government would clearly be justifiable even under *Container*'s standards. Indeed, the residence country of a foreign-owned group can find itself facing an unacceptable choice: either to allow its multinational companies to be double taxed under worldwide unitary taxation or to forego part of its own tax revenue by providing relief through tax credits (or otherwise) for a second tax that is imposed under a system incompatible with its own. The circumstances here present—in sharp contrast to those in *Container*—clearly justify retaliation and, therefore, require a holding of unconstitutionality under the Foreign Commerce Clause.

C. Substantial Nexus

The remaining Dormant Commerce Clause test which the Government of the United Kingdom wishes to address in this brief *amicus curiae* is the nexus test. It requires that the tax in question must be applied "to activities with a substantial nexus with the taxing State." *Japan Line*, 411 U.S. at 444.

Prior to this Court's decision in *Quill* v. *North Dakota*, 112 S.Ct. 1904 (1992), it had been assumed that some form of "minimum contact" between the activity and the taxing state satisfied both the Due Process and Commerce Clause requirements for "nexus." In *Container*, for example, this Court considered the "nexus" issue solely in those terms. 463 U.S. at 165-166.

Quill involved the question whether companies selling goods into a state by mail order could be required to collect the state's use tax. This Court held that they could not unless they satisfied the more stringent Commerce Clause "nexus" requirement by maintaining a physical presence in the state. In its decision in *Quill*, this Court made it clear that the "nexus" standard under the Commerce Clause is a higher standard than under the Due Process Clause because the Commerce Clause is concerned with

the extent of the actual burden being imposed on commerce by the tax in question. Due Process, by contrast, is concerned only with whether the taxpayer was sufficiently connected with the state to be a proper subject of taxation.

As was stated in *Quill*, the "substantial nexus" test imposed under the Commerce Clause serves to "*limit the reach* of State taxing authority so as to ensure that State taxation does not unduly burden interstate commerce." *Quill*, 112 S.Ct. at 1913 (emphasis added). (While *Quill* was an interstate commerce case, the same principles underlie the "substantial nexus" test in the foreign commerce area. *Japan Line*, 441 U.S. at 444-445.)

It seems clear from *Quill* that the extent of nexus required under the Commerce Clause is influenced by the nature of the burden imposed on commerce. Since foreign commerce is involved here, the issue would seem to be particularly sensitive because of the various ways in which a state tax might interfere with the conduct by the United States of its foreign commercial relations.

Under worldwide unitary taxation, the California tax base consists of the combined net incomes of all the corporations in the Barclays group, i.e., more than 220 separate corporations doing over 98 percent of their business outside the United States. App. at B-26. The question presented under the Foreign Commerce Clause is whether there is sufficient nexus between California and the activities of those corporations in the countries where they operate to justify including the income derived from those activities in the California tax base. The answer must be in the negative for at least two reasons.

First, there is no indication of any meaningful contact between the State of California and the activities of the various corporations in the Barclays group that operate in the 59 countries other than the United States. To find

Commerce Clause nexus in the absence of any meaningful contact is clearly inconsistent with *Quill.*

Second, the extraterritorial reach of California's tax has placed a severe burden on foreign commerce. Not only does it generally interfere with inbound international investment decisions because of the inevitable exposure of such investment to double taxation, but it also has created an international reaction of major proportions. (The United Kingdom, the largest foreign direct investor in the United States, reached the brink of economic retaliation before California amended its taxing scheme in 1993.) In the view of the Government of the United Kingdom, California should be denied the ability to include the worldwide income of foreign-owned groups in its tax base because of the extraordinarily heavy burden its unitary tax has placed on foreign commerce.[11]

The only possible basis upon which a claim of sufficient nexus could rest here would derive from the fact that, under California law, the Barclays group conducts a "unitary business." The theory underlying the unitary method of taxation is that certain intangible "flows of value" within the unitary group serve to link the various members together as if they were essentially a single entity. That linkage may have caused the trial court below to conclude

[11] This analysis need not apply with respect to domestic-owned groups with foreign subsidiaries. In those situations, it can be assumed that all the income earned by the group will be remitted to, or realized by, the domestic parent at some point in time. The burden placed on commerce by worldwide unitary taxation is thus much less severe in such a case, because it is only a matter of timing as to when the state would be able to reach—and tax—the income in any event.

The same cannot be said of foreign-owned groups with domestic subsidiaries. The income of such a group will flow away from the unitary tax state, not toward it. Under those circumstances, therefore, the state is seeking to tax income which it would not be able to reach either then or at a later time.

that California had the requisite nexus with every member of the Barclays group.[12]

While such intangible flows of value may be the rationale for treating a multinational group as a unitary business, their rather speculative "subtle and largely unquantifiable" nature (*Container*, 463 U.S. at 164-165) make them too insubstantial to provide the requisite linkage for Commerce Clause nexus. *Quill* suggests that something far more tangible is required.

* * * *

In the view of the Government of the United Kingdom, California's system of mandatory worldwide unitary taxation as applied to foreign-owned groups goes beyond what is contemplated by the U.S. Constitution because of (1) the inevitable exposure of foreign-owned groups to the substantial risk of double taxation, (2) the manner in which the tax interferes with inbound investment decisions and thereby impacts on the conduct of U.S. foreign commercial relations, and (3) the extraterritorial reach that sweeps into the tax base income earned from international activities with which the state has insufficient contact to provide substantial nexus.

[12] That is not entirely clear, however. The trial court actually appeared to accept the nexus analysis adopted in *Container*, which, as noted, was a "minimum connection" analysis. *See* App. at A-30 - A-31.

CONCLUSION

For all the foregoing reasons, the decisions of the courts below should be reversed and California's mandatory worldwide unitary taxing scheme should be held unconstitutional.

Respectfully submitted,

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